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RULSDMK/DEPT OF TRANSPORTATION WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
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UNCLAS SECTION 01 OF 04 MUMBAI 000569

SENSITIVE
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TAGS: ECON EFIN ETRD ENRG IN
SUBJECT: INDIAN INFRASTRUCTURE FINANCE GRAPPLES WITH NEW REALITIES
DUE TO FINANCIAL CRISIS

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¶1. (U) Summary. The global credit crisis has hit infrastructure finance in India, making it difficult for financiers and development companies to raise funds to start or continue projects. While slow execution, regulatory uncertainty, high commodity prices, and investment barriers have slowed the expected inflow, difficulties in ensuring a steady flow of investment has exacerbated these problems. At two conferences in Mumbai, infrastructure fund managers asserted that India would miss its infrastructure development targets this year, and for the next five years. Private equity players, particularly those with no need to raise additional capital, appear poised to be beneficiaries of the current problems in the capital markets and expect large, well-known developers to turn to them for financing. Over the last few years, due to countrywide scarcity of power, the power sector attracted the interest of financiers and developers. However, the capital crunch and the lack of debt financing is starting to affect investment opportunities in this area as well. In addition, financiers confirmed that increasing construction capacity was solving at least one bottleneck in the infrastructure development sector. End Summary.

McKinsey Managing Partner Paints a Gloomy Picture
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¶2. (U) At the Mckinsey infrastructure conference held on 16h October, Anil Zainulbhai, the managing partner of McKinsey India, noted that over a year ago, U.S. Treasury Secretary Paulson and Indian Finance Minister Chidambaram opened an infrastructure conference in Mumbai at which participants agreed that implementation, and not capital, was the main inhibitor to India's infrastructure development (reftel B). In this conference, Indian leaders estimated that the country would need to spend close to USD 500 billion on infrastructure in the next five years, with approximately USD 150 billion coming from the private sector. With the current global financial crisis, the situation has changed dramatically, with multiple projects chasing scarce liquidity. According to Zainulbhai, governments are struggling to fund their huge infrastructure investments,

estimated at USD1.6 trillion a year. This includes investments of about USD860 billion in high income countries, and USD670 billion in low income countries; in comparison, he said, India's target of about USD100 billion a year looks small. Zainulbhai said that given India's slow execution, the country would have missed its target for infrastructure spending of USD 500 billion even without the global financial crisis.

¶3. (SBU) Also at the conference, Singapore-based infrastructure financier Jaap Kalkman of Arcapita agreed, stating that the recent boom in infrastructure spending was built on the belief that low interest rates would remain. This assumption was reinforced by increased investment interest from the developed world, as investors looked to infrastructure as a new, low-risk asset class. Three "uninvited guests" spoiled the party, he said: high oil prices, the economic downturn, and the credit crisis. He predicted that three forces will cause India to fall short of its projected infrastructure investment target. First, high interest rates and the economic slowdown will depress the number of deals in the pipeline. Second, problems with land acquisition will impact the pace of implementation of projects. Third, the government's slow and lengthy project approval process will ensure that India's targets will not be met. He agreed with McKinsey& Co.'s prediction that the shortfall for the current five year plan will be USD160-170 billion.

Infrastructure Developers See Some Upside Emerging from the Gloom
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¶4. (U) According to Zainulbhai, infrastructure financiers face a number of challenges. While the Public Private Partnership (PPP) model is in favor now globally, financiers have not seen a strong record of success in low income countries like China and India, as well as the developed world. In developing countries, the PPP model has many risks, such as design and development risks, contractual risks, a lack of skilled labor, and

regulatory uncertainty. He noted financiers are increasingly aware that leverage has proven to be a double-edged sword; in upmarkets, leverage makes valuations go up even more but in downmarkets leverage works against the investor. As a result of the crisis, players with high leverage and short-term financing have been hit the most. Finding debt financing is harder and more expensive and new deals have slowed significantly. However, he foresaw increased opportunity for developers with proven excellence in operational execution. The full impact of the crisis on infrastructure is possible lower leverage, increased debt costs, and reduced availability of public funds, though the extent is unclear in India, he said.

¶5. (SBU) Nevertheless, infrastructure experts see some silver lining in these clouds. Zainulbhai acknowledged that moderating commodity prices, as well as slower demand growth for transportation and energy, will reduce input costs for the infrastructure development as well as lower the immediate need for the projects. . In another conference organized by Macquaire Capital, Issac George, the Chief Financial Officer of GVK Industries, a major Indian infrastructure firm, said that the limited supply of equity will ensure that the better projects are financed. Parvez Umrigar, the Managing Director of Gammon Infrastructure Investment, another large Indian construction company, believes that the financial crisis will eliminate non-serious players and limit bidding to qualified and seasoned companies. Praveen Sood, the Chief Financial Officer of Hindustan Construction Company, believes that infrastructure financiers and developers should look at the financial crisis as an opportunity to grab more projects. He noted that Warren Buffet has said that when the world is greedy, you should be fearful and when the world is fearful, you should be greedy.

More Could Be Done to Make Financing Easier
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¶6. (SBU) According to Kalkman, the Indian government has provided a better regulatory framework for FDI in

infrastructure, particularly for the power sector, than Brazil and China, but bottlenecks in financial regulation remain. He stated that the Reserve Bank of India's limit for external commercial borrowing (ECB) of USD 500 million per infrastructure project with a maximum interest rate of LIBOR plus 500 basis points (bps) was unrealistic in the current environment. Currently, infrastructure projects cannot readily raise high yield foreign funds (mezzanine funds) for infrastructure projects, he continued. Kalkman predicted that multilateral agencies could come back into favor, but a time-consuming application process could prevent how many projects could tap this route.

¶7. (SBU) McKinsey's Anu Madgavkar, partner in its banking and infrastructure practice, agreed with these problems and stated that India's savings and capital markets have not allocated sufficient funds to infrastructure development. She said that over the next five years banks and non-banking financial institutions (NBFIs) will have USD465 billion of additional capital to invest. Looking at historical trends, she projected that only 8 percent of that capital would be available for infrastructure investment. To fix these financing bottlenecks, she proposed a series of recommendations. First, the ECB approval process should be simplified and the interest rate cap be eliminated to facilitate mezzanine financing. Second, she recommended that government provident funds, which currently cannot invest in infrastructure projects, should be asked to invest a minimum allocation in infrastructure, and banks should be allowed to raise infrastructure bonds that qualify for Statutory Liquidity Reserve Ratio (SLR) status. (Note: Indian banks must invest a minimum amount of their capital into government securities, known as the SLR, currently at 24 percent. If infrastructure bonds gained SLR status, they would not be counted in the overall loan book of the bank, making the bonds more attractive. End Note.) Third, the government should accord priority sector status for infrastructure which would ensure that a minimum amount of capital was supplied to the sector even in times of capital scarcity , and reform the corporate bond market. She also recommended that the

government should allow new sources of foreign capital in addition to private equity, like sovereign wealth funds and global pension funds as well as create new tax incentives for direct infrastructure funding. She also proposed that new mechanisms be created to channel new funds, like putting a portion of foreign exchange reserves into infrastructure or replicate the National Highways Authority India model of a special purpose fund funded by a cess to invest in different infrastructure sectors. If these measures are undertaken, then more of India's domestic savings can be channeled into infrastructure development.

Still No Municipal Bond Market

¶8. (SBU) Sanjay Palve, Country Head of Infrastructure Banking at Yes Bank, pointed out an often overlooked problem: there is no proper structure for municipal governments to raise finance. As a result, well-known metros like Mumbai found it much easier to obtain financing than smaller ones like Bhivandi, a municipality in Maharashtra. Amit Tandon, Managing Director of Fitch Ratings, noted that it was because of this gap that his company had become the first to start rating Indian municipalities, which had been greeted by much enthusiasm. Shailesh Phatak, Managing Director of ICICI Ventures, remarked that urban infrastructure has been completely overlooked in the current Five Year Plan, and he hoped that this would change in the next. (Note: The government has started a multi-year urban renewal "mission" to co-fund infrastructure projects, like sanitation and waste management, with municipalities. End note.)

Private Equity Players Poised to Reap Benefit from Problems in Public Markets
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¶9. (SBU) Responding to media reports that private equity players will be the beneficiaries of the current financial turbulence, Gopal Jain, Managing Partner of Gaja Capital Partners, stated that private equity professionals have two jobs: the first is raising capital for investment and the second is investing. He stated that those funds needing to raise capital may run into problems, but capitalized funds will have rich pickings after the crisis blows over. M.K. Sinha, CEO of IDFC Project Equity, told Congenoffs that IDFC had raised a USD 900 million infrastructure fund, in two tranches, by early August. (Note: Initially proposed during the November 2006 U.S.-India CEO Forum meeting in New York, this fund has been raised in partnership with Citibank and several other international partners. It was originally slated to raise up to USD 5 billion, but now has more modest funding goals. End Note.) According to Sinha, the timing was fortunate, as American investment has now frozen up, and most of the USD325 million that he raised in his second fund came from Middle Eastern investors. He added that the bear market had made American investors risk averse, and wary of infrastructure investment in particular, to which they had little previous exposure. On the investing side, Sinha stated that because equity and debt markets have begun to dry up, he was beginning to see an improvement in the quality of projects coming to him, as better players need financing not available in the markets. He predicted that companies that would normally go to the public markets for capital, like GVK and GMR, will soon seek private equity funding. When pressed on the topic of carbon credits in infrastructure projects, he commented that last year he would have taken into account carbon credits before they had been accredited; now, however, he is waiting until the U. N. Framework Convention on Climate Change approves them. (Note: Echoing these comment, another infrastructure-related company, Ispat Energy and Steel, confirmed that it is now seeking private equity investors for project funding instead of the capital markets.)

¶10. (SBU) Despite the "drying up" of foreign capital, Pathak expressed confidence that it would return to India. He saw his local private equity fund as perfectly placed to be a partner for foreign investors who wanted to invest in Indian projects. For example, he stated that he is currently in discussion with

the private equity arm of an American investment bank for a partnership agreement in which the bank would invest alongside his fund or invest directly into his fund.

Power: Receiving Great Attention Amid Great Challenges and the Capital Crunch
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¶11. (SBU) Power, one of the sectors needing the most investment, is also the sector receiving the most amount of attention. M.K. Sinha remarked that power sector investment is attractive in any scenario because of India's persistent power deficit, coupled with an improved regulatory environment. R.K. Dash of the State Bank of India (SBI) stated that though his firm was supporting a large number of power projects, he saw several bottlenecks. For many projects, coal linkage may be problematic and the distribution sector needs reform. He also noted that the power equipment manufacturing capacity is limited in India. The domestic power equipment manufacturer, Bharat Heavy Electrical Limited, is booked for the foreseeable future, he continued. Some developers are turning to Chinese equipment makers, but the quality of their products is questionable. He clarified that even though some companies have had success with Chinese equipment, there are concerns in the private sector and the Indian government that this equipment is not durable. In addition to these sector-specific concerns, Anu Madgavkar cautioned that in November 2008, the power sector started to be affected by the capital crunch, Indian banks began to hit their lending limits for this sector. This is especially true for the Ultra Mega Power Projects. She noted that private equity players were still looking to invest in power, but the

complementary debt funding that is needed has dried up. However, she said that given the persistent power deficit in the country, this should be one of first sectors to bounce back when debt-financing was once again available.

One Bottleneck Improving: Increasing Construction Capacity
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¶12. (SBU) One year ago, Sanjay Reddy, Vice-Chairman of the GVK Group, cited the dearth of sizeable construction companies as a key bottleneck in the development of infrastructure in India (reftel B). However, some infrastructure financiers say this has changed. Sreekumar Chatra of Macquerie Capital noted that in recent years, a number of mid-sized construction companies like Gammon, Simplex, Punj Lloyd, and IDRCL are emerging as leaders in the construction sector. He also noted that in some specialized cases, companies that normally were not construction experts had learned specialized construction skills. Bhavin Shah, Vice-President of the Mundra Port and SEZ for the Adani Group, agreed, noting the Adani Group had constructed much of its port and SEZ facilities itself.

¶13. (SBU) Comment: Last year, international investors promised that a "wall of money" was waiting to invest in Indian infrastructure. This promise was held out as an incentive to push Indian policymakers and developers into speeding up reforms that would allow Indian infrastructure development to keep pace with the demands of a growing economy. Due to problems with the international financial markets, infrastructure financiers say this "wall" no longer exists. This year, high commodity prices drove up input costs dramatically, followed by a global credit crunch and falling capital markets. Though commodity prices have fallen, infrastructure and development companies are still having difficulties raising funds to begin or continue their projects. Particularly notable is that power projects which first appeared to be surviving the capital crunch are currently having trouble achieving financial closure due to the problems attracting debt financing. The RBI's moves to encourage more ECBs in infrastructure appear to have not worked so far; according to central bank data, corporates raised USD 1.12 billion through ECBs in October, less than half of USD 2.8 billion raised in the previous month. In the meantime, infrastructure developers maintain that Indian infrastructure spending is stagnating. End Comment.
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